

ZAMANSKY & ASSOCIATES, LLC

Attorneys at Law
50 Broadway - 32nd Floor
New York, New York 10004
Telephone (212) 742-1414
Facsimile (212) 742-1177
E-Mail - JAKE@ZAMANSKY.COM
Website: www.Zamansky.com

Jacob H. Zamansky
Edward H. Glenn, Jr.
Kevin D. Galbraith

SPEAKER: Jacob H. Zamansky

TITLE: Reforming Wall Street: State Regulators Cannot Do It Alone

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OVERVIEW: State Securities regulators deserve a tremendous amount of credit for instituting real change and extracting meaningful settlements as a result of cases brought against Wall Street in the aftermath of the financial crisis. However, state regulators cannot police Wall Street in a vacuum. In passing the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), Congress tried -- but failed -- to make the market fair and more transparent for individual investors. Until the SEC, through its enforcement actions, holds high-ranking corporate executives accountable for their firms’ wrongdoing and ensures that settlement fines do not unjustly harm shareholders, measures to protect investors from Wall Street malfeasance will continue to fall short of the mark.

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With the Dodd-Frank Wall Street Reform and Consumer Protection Act now passed, are individual investors -- the proverbial Moms and Pops that bear the brunt of Wall Street shenanigans -- any better protected? Should they sleep a bit more soundly at night?

Unfortunately, the answer is a resounding “no.”

Truth be told, the fundamental change we so desperately need in our financial regulatory system is now more uncertain than ever. Not only does the Dodd-Frank Wall Street Reform and Consumer Protection Act lack any truly substantive reforms that can protect Main Street and individual investors, but the sheriffs given the shiny gold badges to implement what little protections are in place, are the very same Wall Street lobbyists and regulatory agencies that are responsible for the crisis in the first place.

Yes, the SEC has arranged some high-profile Wall Street settlements recently. But are any of them substantive enough to serve as a deterrent to others on Wall Street? Hardly. If anything, Wall Street now knows that while the potential fines they face may have been taken up a notch -- which, let's face it, impacts shareholders' wallets mostly -- the executives that played a hand in the chicanery breathe easier knowing that they now operate with near impunity. Moreover, the United States Justice Department has yet to successfully prosecute any major Wall Street cases.

Where the Feds Have Fallen Short, State Regulators have Shined

When you look at the missed opportunities to strengthen investor protections and all the "should haves" and "could haves" that go with it, perhaps nothing stands out as starkly as the SEC's enforcement record.

When you look at the enforcement record of state regulators, however, it is a much different picture. Indeed, state regulators have done most of the heavy lifting and have extracted the most meaningful settlements since Wall Street nearly dragged the economy into the abyss in 2008. There have been many, many aggressive cases filed by state securities regulators since then, including those notably filed by Massachusetts Secretary of State William Galvin; Mark Connolly, former Director of Securities Regulation for New Hampshire; and Andrew Cuomo, Attorney General for the State of New York.

In Massachusetts, Secretary Galvin ordered Bear Stearns, now part of JP Morgan & Co., to pay back 100 percent of any losses suffered by Massachusetts residents who invested in the firm's

now infamous, sub-prime-laden hedge funds. He also was among the earliest regulators to take action against Wall Street for misleading investors about auction rate securities, and he has ordered the Madoff feeder-fund Fairfield Greenwich to pay its investors every penny they lost.

In New Hampshire, Mr. Connolly filed charges alleging UBS inappropriately sold 100% Principal Protected Notes (PPN) issued by Lehman Brothers, which were rendered basically worthless after Lehman collapsed. His case is especially significant because, unlike the SEC, Mr. Connelly wasn't afraid to use the word "fraud" instead of the more timid -- and less legally actionable -- term "misleading investors."

And in New York, State Attorney General Andrew Cuomo has been instrumental in holding Wall Street's feet to the fire, notably forcing Wall Street firms to repurchase billions of dollars in auction rate securities. He even bravely took on the issue of executive pay on Wall Street, known to be the "third rail" of New York politics.

The Gap Widens Between Enforcement and Deterrence

Indeed, the accomplishments of state regulators should be acknowledged if for no other reason than to highlight the comparable failings of our federal regulators as well as Wall Street's own watchdog, FINRA.

For example, last month FINRA loudly pronounced that it fined Morgan Stanley \$800,000 for failing to adequately disclose analysts' conflicts of interest to investors in nearly 6,500 research reports. A wrist-slap to be sure, but it's especially egregious because the infraction goes to the heart of disclosure regulations and the fact that Morgan Stanley is a repeat offender. The firm was charged in 2006 by the NASD for nearly the same violations, paying a measly \$200,000 penalty.

At the end of the day, it becomes a cost-benefit analysis for Wall Street. The cost of getting caught, both in terms of their reputation and monetary fines, is simply not as powerful as the siren call of ill-gotten revenues.

The SEC needs to take much stronger, bolder steps to fulfill its responsibility to the investing public. Its current actions are simply not getting the job done, and thankfully the Federal Bench is taking notice. Judge Jed Rakoff of the United States District for the Southern District of New York famously struck down the SEC's initial settlement with Bank of America for its allegedly fraudulent disclosure of Merrill Lynch's losses prior to its acquisition. Judge Rakoff referred to a revised settlement package as at best, "half-baked justice" in part because individuals were not held accountable, fines unjustly impact shareholders, and the penalties are inconsistent with the allegations.

More than a year later, settlements are still being announced that appear to be designed by the Wall Street attorneys themselves, protecting the senior executives involved in the schemes and avoiding exposure to private litigation. A recent settlement with Citigroup is Exhibit A. For failing to disclose some \$40 billion in toxic assets to investors, Citigroup was fined a paltry \$75 million. And in what has become commonplace, the SEC brought cases against just two Citigroup executives who were only asked to pay a \$180,000 fine *collectively*, and managed to avoid admitting wrongdoing or even a mention of the word "fraud" in the settlement agreement.

Like Judge Rakoff, U.S. District Judge Ellen Segal Huvelle has refused to approve the SEC's settlement with Citigroup frustratingly asking the attorneys representing the SEC and Citigroup, "Why would I find this fair and reasonable?"

Exhibit B is the SEC's settlement with Goldman Sachs for its dubiously structured ABACUS-CDO transactions. The SEC's long awaited settlement with Goldman was so one-sided that Goldman's stock shot up the day the settlement was announced. And in typical fashion, the SEC let Goldman Sachs the corporate entity off easy while targeting and scapegoating a lowly vice

president named Fabrice (“Fabulous Fab”) Tourre, who was likely just doing the bidding of those to whom he reported.

Such enforcement practices are hardly deterrents. To have even a modicum of success in that regard, the SEC needs to be firm in holding high-ranking corporate executives accountable and ensure that penalties and fines stemming from Wall Street malfeasance do not unjustly harm shareholders.

Dodd-Frank and Investor Protections

Dodd-Frank was supposed to be an unprecedented shield protecting investors and consumers from the financial industry’s increasingly complex environment. To be sure, in some cases, improvements have been made. But to put it plainly, Dodd-Frank failed overall to offer the kind of meaningful solutions investors actually need.

It was extremely unfortunate that after a considerable amount of stump speeches and political grandstanding, a broad application of the “fiduciary duty standard” -- one of the most important investor protections initially included in the bill -- ended up amongst 150 “studies” called for by Dodd-Frank. Perhaps in some cases more fact-finding is needed, but not with this one. The SEC already studied the fiduciary standard in 2008 and found that investors didn’t know when they were getting actual financial advice as opposed to being sold a product, which is at the core of the “suitability” versus “fiduciary duty” standard debate.

Having nearly 30 years of experience as a securities attorney, I can tell you with certainty that it is far more difficult to recover investments lost as a result of broker fraud under the suitability standard than it is under the fiduciary duty standard.

The need for a broad fiduciary duty standard could not be stronger as Wall Street continues to introduce increasingly complex and esoteric products targeted at individual investors, collectively known as “structured products”. According to the news website

StructuredRetailProducts.com, through mid-August 2010 Wall Street sold some \$30 billion worth of structured products to U.S. investors with catchy names ranging from ELKS, PACERS and STRIDES, to SPARQS and ELEMENTS. Financial risk expert Chris Whalen recently published a paper calling such structured products, “the next investment bubble.”

I represent dozens of investors, mostly retirees, who were sold structured products by their brokers, including Lehman’s worthless 100 % PPNs, which were marketed aggressively by brokers from UBS.

Lehman’s PPNs and products like it are a particularly bad call for elderly investors who rely on their principal for investment income to primarily cover their day-to-day expenses. Audaciously, Wall Street is preying on this vulnerability by implying in the name itself that an investor’s principal is protected. In reality, nothing could be further from the truth.

Sadly, Wall Street maintains an upper-hand over mom and pop investors because brokers only must prove that structured products like PPNs were “suitable”, even if there are much safer, more appropriate investment alternatives.

To level the playing field, I advocate that before a structured product can be sold to a retail investor, parties must sign a simple, “plain English,” one-page agreement akin to what Wall Street uses when entering into a derivatives contract. It’s what is known as a “Master Agreement.”

After all, derivatives and structured products are both extremely complex and can often look alike; therefore, individual investors should be afforded the same opportunity to understand the ground rules ahead of their purchase.

Among Dodd-Frank’s other failures was neglecting to address important investor issues, including the Supreme Court’s so-called “Stoneridge Decision.” Stoneridge protects Wall Street from “third-party liability” and is one reason why victims of Ponzi schemes may not be able to

recover losses from Wall Street firms that aided and abetted the fraud. The legislation also failed to effectively address a revolving door policy that continues to exist between Wall Street firms and the agencies which regulate them.

To put it in the simplest terms, investors deserve far better from Congress.

State Regulators Remain the Last Line of Defense

While Dodd-Frank addressed many needed issues, investor protections were clearly neglected, suggesting that the SEC’s decades-long period of “light-touch” enforcement policies will likely continue. After all, on Wall Street, history tends to repeat itself. I have every confidence in our state regulators and their ability and zeal to defend individual investor rights within their borders. How unfortunate that federal regulators are reluctant to join them on the front lines, leaving the states to battle alone.

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Jacob (“Jake”) H. Zamansky is one of the country’s foremost authorities on securities arbitration law, the legal recourse for investors claiming broker wrongdoing, or for brokers claiming wrongful termination or other misconduct by their employer. Zamansky & Associates, the New York-based law firm he founded, represents both individuals and institutions in complex securities, hedge fund, and employment arbitration and litigation.